

EXHIBIT 26

Financial Discussion and Analysis

Financial Management Systems

The CDFI Fund's financial statements included in this annual report represent the first stand alone statements prepared by the Fund since its inception in FY 1995. Prior to this report, financial information for the CDFI Fund had been included as part of the Department of the Treasury's annual Accountability Report for FY 1996.

Since the beginning of the Fund, accounting services and financial statement preparation have been performed outside of the Fund in other Treasury offices. Until mid FY 1997, these services were performed by the Financial Management Division in the Departmental Offices. For the last half of FY 1997, accounting services and financial statement preparation were contracted to the Bureau of the Public Debt-Franchise Services.

With these first audited financial statements and stand-alone annual report, the CDFI Fund, a wholly owned government corporation, is not only complying with its enabling legislation, but also conforming to the spirit of the CFO Act of 1990 and the Government Performance and Results Act (GPRA) of 1993. In addition, in the first quarter of FY 1998, a Deputy Director for Management/Chief Financial Officer was appointed for the CDFI Fund and a process begun to establish an internal Fund financial management structure and staff.

Federal Managers' Financial Integrity Act (FMFIA) Highlights

During FY 1997, the CDFI Fund did not have a formal FMFIA program in place to evaluate, continuously monitor and improve the effectiveness of management controls associated with the Fund's programs. Consequently, the Fund's internal control process during this period lacked adequate individual program and

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Based upon the results of a limited review and assessment of the Fund's internal control environment, policies and procedures, the CDFI Fund cannot provide reasonable assurance that its systems of management, accounting, and administrative control, taken as a whole, achieve the objectives of the FMFIA and FFMLA. The Fund also cannot provide reasonable assurance that its accounting and financial systems generally conform to the Comptroller General's principles, standards and related requirements and achieve the objectives of the FMFIA and FFMLA.

Maurice A. Jones
Acting Deputy Director
on January 2, 1998

operating level self-assessment to provide reasonable assurance that its systems of management, accounting, and administrative control, taken as a whole, achieved FMFIA and FFMIA objectives.

A formal FMFIA program enables management to make an assertion that:

- ✓ obligations and costs comply with applicable laws;
- ✓ assets are safeguarded against waste, fraud, abuse, and mismanagement;
- ✓ revenues and expenditures applicable to the CDFI Fund operations are properly recorded and accounted for so that accounting, financial, and statistical reports may be prepared, and accountability of the assets may be maintained; and
- ✓ programs are efficiently and effectively carried out in accordance with applicable laws and management policies.

As a first step towards the preparation of a CDFI Fund Annual Report and audited financial statements for FY 1997, the Fund management initiated an FMFIA review subsequent to September 30, 1997. As a result of this review, which did not include any transaction testing, the following material weaknesses were identified. Currently corrective action plans are being developed with target dates for completion in the first half of FY 1998.

1. Title and Description: (CDFI 97-01) No formal FMFIA Program in place.

CDFI did not have a formal FMFIA program in place during FY 1997 to evaluate, continuously monitor and improve the effectiveness of management controls associated with CDFI's programs. Therefore, all of the Fund's internal control processes lacked adequate individual program and operating level self-assessment.

Status and Accomplishments: Subsequent to September 30, 1997, the CDFI Fund management initiated an FMFIA review to assess its internal controls. This review identified seven material weaknesses and three instances of administrative systems' non-conformance. During the first half of FY 1998, the Fund will establish a formal management control process and designate the Deputy Director for Management/CFO as the Fund's Management Control Officer.

2. Title and Description: (CDFI 97-02) CFO and Controller positions and functions not established.

The CDFI Fund did not hire a Chief Financial Officer (CFO) until after September 30, 1997. Since a CFO's duties would normally include overseeing all aspects of the Fund's administrative, accounting, reporting, management controls, budgetary, portfolio monitoring, and compliance with laws and regulations, these areas were not receiving sufficient management attention during FY 1997. In addition, the Fund lacked a controller (financial manager) to oversee the day-to-day accounting functions, as well as the accounting activities performed for the Fund by the Bureau of the Public Debt. The lack of a CFO and Controller potentially impairs the Fund's

management ability to make sound financial decisions and to monitor the Fund's financial and performance activities.

Status and Accomplishments: A Deputy Director for Management/Chief Financial Officer was appointed in November, 1997. A staff accountant was hired in January, 1998. Additional financial positions are being developed and hiring will continue through the first half of FY 1998.

3. Title and Description: (CDFI 97-03) Awards Administration and Monitoring Positions and functions not established.

The duties of an awards officer normally include serving as the principal procedural authority, advisor and implementer of awards management policies. Key to such a function is the development and coordination of the Fund's awards management program, including the dissemination of procedural and technical advice, guidance and interpretation on CDFI award management activities and requirements, maintenance of award files, as well as sufficient monitoring of the pre- and post-award operations of the Fund. The lack of an awards manager impairs the Fund's ability to carry out the above activities and to monitor CDFI's program performance and compliance activities.

Status and Accomplishments: Policies and procedures for an awards administration and monitoring function are being developed in the first half of FY 1998. An Awards Officer reported for duty in January, 1998.

4. Title and Description: (CDFI 97-04) Post Award Monitoring Procedures not established and implemented.

The CDFI Fund lacked formalized, documented post-award monitoring procedures and responsibilities during FY 1997. Monitoring procedures provide a means to assess the award recipient's compliance with their assistance agreements and to determine whether corrective actions are necessary or accomplished in an efficient and timely manner, and a methodology to aid the CDFI Fund in meeting its goals and objectives. Performance award monitoring procedures normally include, among other things, ensuring periodic financial and performance reports required to be submitted by the awardee are received by the Fund, reviewed, and acted upon accordingly. Monitoring procedures can also include site visits, and ensuring performance objectives are being achieved and the awardee's reporting requirements are being met.

Status and Accomplishments: During the first half of FY 1998, the Fund will:

- ✓ Develop written, formal, ongoing monitoring procedures and forms and place them into operation.
- ✓ Continue with the design and development of a portfolio monitoring database system.
- ✓ Determine the audit guidelines for the CDFI awardees to follow.

- ✓ Track the receipt of all required reporting activities for all CDFI awardees since the inception of the Fund.

5. Title and Description: (CDFI 97-05) No formal review of monthly financial statements and accounting records or completion of supporting reconciliations.

Monthly trial balances and other reports such as spending transaction reports, budget and obligation reports were not routinely reviewed and reconciled to source documentation such as invoices and purchase orders. Where reviews were performed, documentation of the review procedures was not evident. There was no formalized administrative funds control policy or process. Lack of a formalized review of monthly financial statements and other financial reports impairs the Fund's management ability to effectively and adequately monitor the CDFI Fund's financial activities.

Status and Accomplishments: During the first half of FY 1998, the Fund will establish a formal process for preparing and distributing monthly financial statements. The Deputy Director for Management/CFO will establish and implement Fund policies and procedures for the administrative control of funds. Monthly financial statements will be reviewed and any issues acted upon in a timely manner.

6. Title and Description: (CDFI 97-06) Inadequate Delineation of Organizational Responsibilities.

During FY 1997 there was insufficient delineation of organization responsibilities within the Fund. In general, position descriptions were not adequately adhered to and/or do not adequately define the responsibilities of specific positions. The Fund has been understaffed since its inception in a number of key positions. In addition, there are no established procedures for periodically evaluating employee's performance against established performance criteria and goals. This combination of conditions resulted in instances of incompatible duties, lack of accountability, and ambiguous job responsibilities.

Status and Accomplishments: During the first half of FY 1998, the Fund will establish and formalize a new organizational structure centered around a Director and two Deputy Directors, a Deputy Director for Management/Chief Financial Officer and a Deputy Director for Policy and Programs. In addition the fund will:

- ✓ Reevaluate all existing position descriptions;
- ✓ Establish performance criteria and standards for each Fund position
- ✓ Implement a performance appraisal process; and
- ✓ Establish an awards system for employee performance.

7. Title and Description: (CDFI 97-07) Program Award Files not completed.

During FY 1997, the CDFI Fund award files lacked a structured file order format and were not reviewed for completeness. A consistent and structured

format is critical in order to have strong controls over the award process and overall monitoring of awards.

Status and Accomplishments: During the first half of FY 1998, the Fund will finalize an awards Table of Contents and identify all documents that should be included in the awards files for FY 1996 and FY 1997. These files will include all relevant documentation received from applicants, whether or not funds were awarded to the applicant. Files will be set up in accordance with the Table of Contents and each file reviewed for completeness. Thereafter, all files will be maintained in accordance with this master Table of Contents, with files updated timely and maintained in accordance with the Fund's awards administration policies.

Management Responsibilities

The CDFI Fund management is responsible for the fair presentation of information contained in the principal financial statements, in conformity with the accounting hierarchy described in Note 1, Summary of Significant Accounting Policies, which constitutes an "other comprehensive basis of accounting." Management is also responsible for the fair presentation of the Fund's performance measures in accordance with Office of Management and Budget requirements. The quality of the Fund's internal control structure rests with management, as well as the responsibility for identification and compliance with pertinent laws and regulations.

Limitations of the Financial Statements

The financial statements, included as part of this total package, present the financial position and results of operations of the Community Development Financial Institutions Fund for the years ended September 30, 1997, 1996 and 1995 pursuant to the requirements of the Government Management Reform Act of 1994. While the financial statements have been prepared from records in accordance with the formats prescribed by the Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," the statements are different from the financial reports used to monitor and control budgetary resources that are prepared from the same records and are subsequently presented in Federal budget documents. Therefore, readers are advised that direct comparisons are not possible between figures found in this report and similar financial concepts found in the fiscal year 1997, 1996 and 1995 Budget of the United States Government. Additionally, the financial statements should be reviewed with the realization that they are for a sovereign entity (the United States Government), that liabilities not covered by budgetary resources reported in the financial statements cannot be liquidated without the enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS FUND

Reportable Conditions in Internal Control over Financial Reporting

A. Lack of a Formal FMFLA Process and Internal Controls over Procedures

During the Community Development Financial Institutions Fund's (the CDFI Fund) initial operating period (July 27, 1995 to September 30, 1997), critical management personnel were not in place and accordingly, internal control over financial reporting was not established maintained. Although there was limited financial activity at the CDFI Fund during much of this time, and certain financial managers within the U.S. Department of the Treasury (the Treasury) were assigned responsibility for maintaining the financial records related to the CDFI Fund activity, specific responsibility for establishing a system of internal controls and maintaining accountability for CDFI Fund assets was not addressed. As financial activity increased towards the end of fiscal year 1997, the need for separately identified and financially accountable management for the CDFI Fund became more apparent and corrective actions began to be taken.

However, during the period under audit, the following weaknesses in internal controls existed which could have adversely affected the CDFI Fund's ability to ensure that the objectives of internal controls, as previously identified, were achieved:

- Absence of a formal Federal Managers' Financial Integrity Act (FMFLA) program to identify and design corrective actions for material weaknesses
- Lack of a structured system of documentation for award files
- Vacant positions for oversight of awards programs
- Lack of formal post-awards monitoring procedures
- No formal review of monthly financial statements, accounting records, budgetary reports, and supporting reconciliations
- Vacant positions for Chief Financial Officer and Controller
- Inadequate delineation of organization responsibilities within the CDFI Fund
- General lack of documented policies and procedures

As a result of the foregoing, we concluded it was not cost-beneficial to place reliance on any internal controls maintained by the Treasury over financial reporting for the CDFI Fund for fiscal years 1995 and 1996. For the fiscal year ended September 30, 1997, we evaluated and tested relevant internal controls over financial reporting maintained at the Treasury on behalf of the CDFI and, for all three years, performed other substantive audit procedures to the extent we considered necessary to satisfy ourselves that amounts reported in the financial statements were materially correct.

However, we believe immediate and continual attention must be placed on corrective action necessary to eliminate the material weaknesses noted above. Failure to do so, along with the expected increase in financial activity of the CDFI Fund over the next several years, could result in material misstatements in the financial statements and/or material noncompliance with laws and regulations that could have a direct and material effect on the financial statements.

We noted the CDFI Fund has taken important first steps in fiscal year 1998 to address these material weaknesses. Since the beginning of fiscal year 1998, the following critical management positions at the CDFI Fund have been filled:

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|--------------------------------------|---------------|
| • Deputy Director for Management/CFO | November 1997 |
| • Awards Officer | January 1998 |
| • Staff Accountant | January 1998 |

As new personnel join the CDFI Fund, needed policies and procedures are among those items that will be addressed. Additionally, the Deputy Director for Management/CFO brought in contractors to perform an FMFLA assessment for 1997 during the first quarter of fiscal year 1998. The plan is for this assessment to be performed internally in the future and become a part of the CDFI Fund annual financial reporting process.

Plans to establish formal policies and procedures for administrative control of funds and reviews of monthly financial statements are currently being addressed by the Deputy Director for Management/CFO. Also, with the appointment of an Awards Officer, policies and procedures for post-award monitoring of awardees and awardee file maintenance are being addressed. Finally, we were informed by the Deputy Director for Management/CFO that the Fund plans to evaluate its structure and operations, to determine whether there are more efficient ways of accomplishing their goals and carrying out their mission.

Recommendation

We believe that the CDFI Fund has developed some strong plans for accomplishment in fiscal year 1998. We recommend that the CDFI continue to implement its plans and monitor whether their implementation is achieving their goals.

Specifically, action must be taken to:

- Establish a formal management control process and designate the Deputy Director for Management/CFO as the Fund's Management Control Officer
- Develop additional financial management positions and recruit personnel to fill these positions as soon as practicable
- Develop policies and procedures for an awards administration and monitoring function, in the first half of fiscal year 1998
- Develop formal, ongoing monitoring procedures, and related forms, and place them into operation

- Continue the design and development of a portfolio monitoring database
- Determine and communicate audit guidelines for the CDFI Fund awardees to follow
- Track the receipt of all required reporting activities for all the CDFI Fund awardees since the inception of the fund
- Establish a formal process for preparing, reviewing and distributing monthly financial statements, including specific procedures for follow-up on any issues identified during the process
- Finalize the awards file maintenance program and develop a "file contents checklist" to identify all documents that should be included in the awards files

B. Recognition of Grant Award Expenses

The CDFI currently administers two grant award programs -- the CDFI Fund program, and the BEA program.

The CDFI program awards grants to awardees based on projected performance and with the condition that the awardee certify that eligible matching funds are available. Once a program assistance agreement is signed as evidence that the projected performance is approved and matching funds are certified as available, the CDFI Fund has incurred a liability to disburse the grant funds to the awardee. Awards are not made on a reimbursement basis, and the awards are revocable only for failure to meet performance goals or other material noncompliance with program provisions.

The BEA program awards institutions for past performance and in anticipation of future performance goals set by the institution. The awards can be made over a period of time or all at once. Before payment is made, the BEA recipient must demonstrate that it has met the performance goals it set. Once the awardee has demonstrated that it has met its performance goals, a payable should be recognized by CDFI because no further action on the part of the awardee is required to "earn" the award.

Our audit revealed that liabilities incurred as a result of the awards process as described above had not been recorded by the CDFI Fund as earned by the awardees, but rather as the awards were disbursed. As a result, awards payable were understated by \$19 million and \$9.4 million at September 30, 1997 and 1996, respectively. Audit adjustments to record the awards payable and related grants expense were made by CDFI to correct these accounting errors.

Recommendation

We recommend that the CDFI Fund record payables for grant awards and related grants expense at the point in time when the awards are earned by the awardees, rather than when disbursed in cash.